MANUFACTURERS HANOVER

Economic Report

February 1990

Commentary on Pertinent Economic Issues

Irwin L. Kellner
Chief Economist

Monetary Policy Dilemmas

The story of the U.S. economy is becoming more and more like a soap opera. Almost every day a statistic is released or an event occurs that shifts prevailing opinion one way or another. And in this day of worldwide electronic linkups and instant news dissemination—not to mention the internationalization of money flows and the increasing interdependence of national economies—these attitudinal changes are immediately reflected in a wide variety of financial market instruments. Interest rates in the bond and money markets have become increasingly volatile, as have foreign exchange rates, stock prices, and prices of precious metals, oil and many key commodities. In turn, these signals have begun to influence policymakers around the world—especially central banks, where reactions can be relatively swift.

Back home, our central bank, the Federal Reserve, has been preoccupied with trying to achieve price stability in a constantly-changing environment. The Fed has not tried to keep monetary policy on "automatic pilot," fearing that wide swings in the "real" economy might result. Yet, it apparently has concluded that it cannot ignore trends in the monetary aggregates—the various measures of the money supply—for they seem to have at least long-run significance. This has produced a rather eclectic monetary policy, dominated by no one indicator, but rather, by many. While such a policy has enabled the Fed to be more responsive to current economic needs and market concerns, it has heightened the need for the central bank to be able to filter out signals from noise—no small task in this era of confusing statistics and constant revisions.

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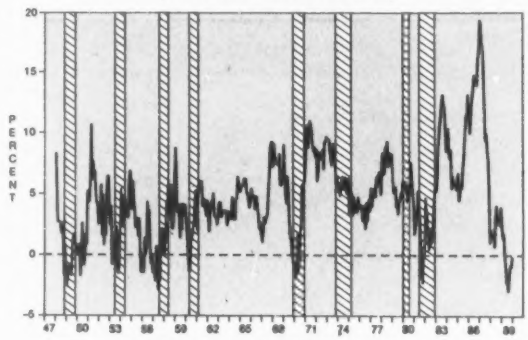
The Fed Has Eased—Barely

Over the past year, the Fed has shifted the focus of monetary policy from progressive restraint to somewhat less restraint. Although the key Federal funds rate has fallen by about 1½ points since last April, and the two narrower measures of the money supply, M1 and M2, have grown fairly rapidly since the middle of last year, the broader measure, M3, continues to grow only slowly, while total bank reserves (adjusted for reserve requirements) are no higher than they were a year ago—after plunging by the steepest year-over-year rate in the postwar era last summer (Chart I). What is more, the markets have begun to suspect that this is about as easy as the Fed is going to get—at least for now.

CHART I
TOTAL BANK RESERVES
ADJUSTED FOR RESERVE REQUIREMENTS
(12-MONTH PERCENT CHANGE)



Source: Federal Reserve Bank of St. Louis

To be sure, some market participants would not be unhappy if the Fed were to call a halt to its 10-month policy of allowing short-term interest rates to decline. They point to the rate of inflation—which last year worsened both at the consumer and at the producer level, reminding us that this is not in keeping with the Fed's stated goal of achieving price stability within a few years. And while prices of many industrial raw materials did fall last year, labor costs—whether measured in terms of total compensation, or in costs per unit of output, rose faster last year than the year before.

These participants have registered their displeasure over the prospects for additional Fed ease by selling bonds. As a consequence, yields on long-term bonds have climbed sharply in recent weeks. After touching a 2¾-year low of 7.83 percent in the middle of December, yields on the bellwether 30-year Treasury bond climbed to 8.55 percent six weeks later. However, before the Federal Reserve concludes that it should not ease further, it should take into account two points: (1) A lot of this selling has been by foreigners, principally the Japanese, reacting to conditions in their own markets; (2) The U.S. economy is undeniably weak and could get weaker, still.

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Since the first element is neither likely to be long lasting, nor under the control of our monetary authorities, it is more useful to examine the second. There is no denying that the U.S. economy ended 1989 on a soft note. The real gross national product in last year's fourth quarter rose only 0.5 percent at an annual rate—the slowest quarterly rise since second-quarter 1986. Then, it was the weakness in the Oil Patch, overlaid on what was a two-year slump in manufacturing because of the dollar's earlier strength that pulled the overall GNP down.

This time, the decline appears to be more broadly based: Consumer spending fell, production of autos and most other durable goods (with the notable exception of commercial aircraft) declined, while homebuilding sank to its lowest levels since the 1981-82 recession. In addition, exports, which had been a source of strength in 1987 and 1988 (following the decline in the dollar between February 1985 and early 1988), stopped growing in the middle of 1989 (reflecting the dollar's subsequent rebound). Not surprisingly, factory payrolls have fallen for nine straight months—the longest such decline since 1986, when they were down eleven months in a row.

Let's not forget fiscal policy. Although Washington's eight-year string of 12-digit budget deficits has shifted fiscal policy into stimulative overdrive, the deficit is now getting smaller both in relative as well as in absolute terms. What is more, it could become even less stimulative, if the Administration's plan to trim defense spending comes to fruition and is not offset by increases in outlays in the nondefense sector and/or by tax cuts. It might be stretching things a bit to worry about fiscal policy becoming too restrictive at this stage—especially when a smaller deficit would entail less borrowing by Washington, and thus lower interest rates—but it is something that bears watching. Moreover, other countries have tightened up their economic policies, which could slow our economy further by reducing the demand for our exports.

The reluctance with which the Fed has eased monetary policy since last April, not to mention the statements attributed to several Fed governors that further easing is unnecessary because the economy has passed through the worst of the slowdown and the present rate of inflation remains "unacceptable," suggests that the monetary authorities have a great deal of confidence in their ability to manage the U.S. economy—moreso than may actually be the case. It may be true that monetary policy can be used effectively to restrain the economy, but it does not necessarily follow that monetary policy alone can stimulate activity, when such a move is called for.

Pushing On A String

This was the situation in the 1930s, you may recall. At that time, the U.S. economy was spiraling downward, in what was to be known as the Great Depression. Recognizing that it had tightened money when it should have loosened, the Fed proceeded to flood the banking system with reserves, in the hopes of driving interest rates down low enough to stimulate the borrowing necessary to increase spending. Rates came down all right, but the banks refused to lend and people were reluctant to borrow. This gave rise to the expression, "You can't push on a string."

In many respects, we are in the same circumstances today. The deflation of many asset values, such as real estate, along with the huge debt loads now being borne by consumers and corporations and the contraction of the "junk" bond market, has begun to affect attitudes toward credit on the part of both borrowers and lenders. Those who in the past might have been counted on to borrow at the first sign of easier money and lower interest rates are more reluctant this time around.

Both individuals and corporations are currently shouldering record levels of debt. Total consumer debt outstanding as a percent of take-home pay now amounts to nearly 80 percent, up from 60 percent seven years ago, and the highest in postwar history. For their part America's nonfinancial corporations now have to set aside 43 cents out of every cash flow dollar just to service existing debt. This, too, is the highest in the postwar era—and twice the level of just four years ago.

Lenders, naturally, have become more reluctant to extend credit. Many banks and savings and loans have experienced increased problem loans, thus their lending standards have tightened. In some cases, they are refusing to make loans at all even under the most conservative conditions. The commercial banks in particular have been under pressure from their regulators to boost their capital ratios, and one quick way to accomplish this is to shrink the size of their balance sheets—in other words, to make fewer loans and investments.

In this regard, the Fed's ability to receive the correct economic feedback from the banking system may have been altered. As was pointed out last year (Economic Report—August 1989), one of the Fed's key intermediate target variables in the past few years may have misled the central bank into thinking that it was easier than it actually was. Because of their reluctance to lend, the banks did not borrow from the Fed's discount window as much as the widening gap between the discount rate and the Federal funds rate suggested they should have. Thus the Fed continued to drain reserves from the banking system, pushing the funds rate up sharply in 1988 and early last year until signs of economic softening became too obvious for the Fed to ignore. The banks are still staying away from the discount window—but this does not necessarily mean that monetary policy is all that easy.

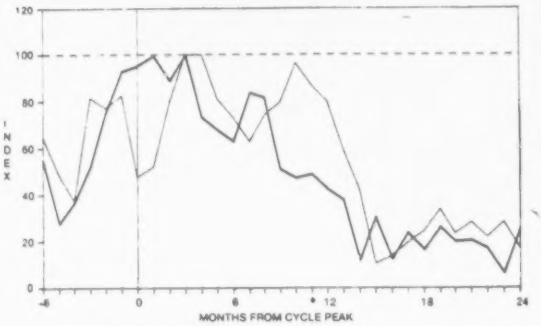
Aside from this, there are other changes one hopes the Fed is aware of. A good part of the weakness in the economy today can be traced to the (mis)fortunes of our two key industries, autos and housing. While lower interest rates and easier financing terms won't hurt, they may not help, either. This is because prices of both new cars and new homes have soared faster than family incomes, making these purchases largely unaffordable to all but a few.

For example, back in 1973, the average family had to work only 17½ weeks to make enough money to buy the average car; today it's over 25 weeks—and this is with more people working per family! Housing is no better. Twenty years ago, the average home cost 2.4 times the average family's income; today it's nearly four times more. Carmakers in particular have encouraged consumers to borrow for longer periods of time in order to enable them to bring their monthly payments back into line with their incomes—but this has had the effect of keeping people out of the market for a new car that much longer.

Braking Inflation Is Hard To Do

If the Fed is waiting for inflation to slow *before* easing monetary policy, it should be aware of the past and the present. A lot of today's inflation is outside the control of monetary policy. For example, December's record cold wave caused prices of energy and foods to shoot up. Oil prices are also determined by decisions made by the oil-producing nations—again outside the purview of the central bank. On the wage side, a large chunk of today's rise in worker compensation traces to factors that have little—if anything—to do with labor's bargaining power. These include the higher costs of Social Security taxes and medical care. As for the past, the record shows that most of the reduction in a given rate of inflation will occur *after* the economy has gone through a recession, and in the first year or two of recovery that follows (Chart II).

CHART II
AVERAGE OF 8 POSTWAR RECESSIONS:
3-MONTH PERCENT CHANGE IN CPI (THICK) VS.
3-MONTH PERCENT CHANGE IN PPI (THIN)
<CPI & PPI PEAKS=100>



*Length of average recession
Sources: Bureau of Labor Statistics; MH

On the other hand, the Fed's freedom to reduce interest rates may be constrained by the very interdependence of national economies and internationalization of money flows referred to at the beginning of this Report. If U.S. interest rates go down too far too fast, they might cause investors from other countries, on whom we have grown increasingly dependent, to dump their holdings of Treasury securities and seek higher returns elsewhere. Given the tighter monetary policies that other central banks are pursuing, this would not be a difficult search. Ironically, this would cause rates on U.S. Government securities to move up, unless the Fed stepped in and bought them, in which case, it would lead to an even easier policy. In the meantime, the dollar would probably fall, helping exports—but at the expense of rekindling inflation from higher-priced imports.

Thus the saga of the U.S. economy goes on, with businessmen, economists and the markets watching to see what the star of the show, the Federal Reserve, will do next. Will monetary policy stabilize, ease—or tighten? Even more important, will the results be what the Fed expects them to be?

Stay tuned. ■

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Inflation: What's The Beef?

Irwin L. Kellner
Chief Economist

Although it is too soon to say for certain that the United States economy has dodged another bullet and avoided a recession, the financial markets have already begun to exhort the Federal Reserve to tighten monetary policy, because they fear an acceleration of inflation. Having missed the turn a year ago (Economic Report—April 1989), when they also thought they saw developing inflationary pressures—only to be blindsided by the effects tight money was exerting on the economy—these Fed-watchers may be too far *ahead* of events, this time around.

To be sure, the economy has managed to pull out of the power dive it went into at the beginning of last October. However, if prices of industrial raw materials—which signaled this plunge as soon as it began—are any guide, all that has happened is that the economy has stabilized at a slower pace of activity than it was running at last summer (Chart I). While this may be the "soft landing" that the Fed has supposedly been seeking, it doesn't necessarily mean that the worst is over—not to mention that tighter money is now de rigueur.

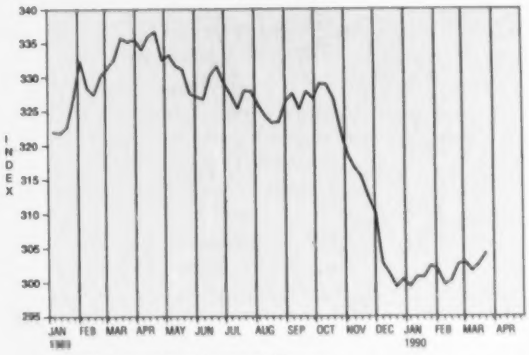
A Hard Landing For Profits

For one thing, major sectors and regions of the economy are still gasping for air. Manufacturing is weak, with output of the nation's factories, mines and utilities up less than one percent over the past year. Construction is depressed; housing starts are barely above last year's levels, while business expenditures on factories, office buildings, shopping centers, warehouses, and the like, were no higher at the start of this year, after adjusting for inflation, than they were 16 years earlier! Exports, the prop under business activity from late-1987 through mid-1989, have slowed. And to top it off, corporate profits are spiraling downward.

This development in particular should stay the hand of the central bank, making it think twice before tightening money and boosting interest rates. For you see, profits are the grease that turns the wheels of American industry. If business makes less, it stands to reason it will have less to spend on materials and supplies, plant and equipment, research and development—and, of course, on labor.

Take capital spending, for example. Chart II shows what happens to business fixed investment when cash flow—which is obviously derived from profits—declines. The same may be said for other types of business outlays, upon which much economic activity depends. To underline their importance to the economy, the quarterly profits data were part of the Commerce Department's index of leading economic indicators until recently. They were dropped when the series was converted to include monthly data only—not because they were no longer considered a reliable business indicator.

CHART I
TUESDAY SPOT PRICE INDEX: RAW INDUSTRIALS
(1967=100)



Source: Commodity Research Bureau

Plainly, profits are falling because many companies face weak markets. This means, of course, that their sales are down, causing per-unit costs to rise. Yet, the soft demand they face prevents them from raising selling prices enough to offset these higher costs. The ratio of prices to unit labor costs is at its lowest point in seven years, as are profit margins. If companies are having trouble raising selling prices to cover their increases in costs—not to mention to widen margins—it is difficult to see where the inflation threat is coming from.

Looking further, one finds not inflation, but deflation at the commodity level. Prices of industrial raw materials are clearly below last year's levels, as you saw in Chart I. At the next stage, producer prices for crude goods less food and energy have been falling, year-over-year since

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last November, and are now 6½ percent below a year ago—the biggest 12-month decline since 1985. As a result, producer prices for goods at the intermediate level, excluding food and energy, are no higher than they were last year at this time—after having been up by as much as 7½ percent yearly in the summer of 1988. As for finished goods, they are rising by the slowest yearly rate since the autumn of 1988; in June of 1989 they were up by the most for any 12-month period in almost seven years.

These trends have percolated up to the consumer. If one looks at consumer prices excluding food and energy—the so-called "core," or underlying rate of inflation most affected by the state of the economy—one finds that they are rising by about 4½ percent, year-over-year, less than last year at this time, and not far from the rate posted during the past five years. This means that most prices the consumer has to pay are rising at the same rate they've been climbing at since the end of 1984—not price stability, but no cause for alarm, either.

But the evidence is not confined to domestic markets. Prices of goods we import are going up much more slowly, too. Because the dollar has climbed against many currencies over the past couple of years, imports' prices have slowed their rate of rise to less than two percent, year-over-year. By contrast, back in the spring of 1987, these prices were shooting up at a yearly rate of nearly 12 percent! Of course, we're paying for this improvement with the flattening in exports noted above, but you can't have everything.

CONSUMER PRICE INDEX: 12-MONTH PERCENT CHANGES
TOTAL, GOODS & SELECTED SERVICES

	Feb. 1983	Feb. 1984	Feb. 1985	Feb. 1986	Feb. 1987	Feb. 1988	Feb. 1989	Feb. 1990
TOTAL	3.5	4.7	3.6	3.1	2.2	3.8	4.8	5.3
Total Goods	2.8	4.4	2.1	1.2	0.2	3.4	4.7	5.4
Total Services	4.3	4.8	5.2	5.3	4.2	4.4	4.9	5.1
Home Maintenance Services	4.0	7.3	3.8	4.1	0.7	4.8	1.7	3.9
Housekeeping	2.5	2.8	2.8	3.3	1.8	1.6	4.7	1.4
Dry Cleaning	5.6	5.8	5.0	4.3	3.5	4.8	5.8	3.8
Auto Maintenance	5.9	3.5	3.2	3.1	3.8	3.9	4.8	3.5
Medical Care Services	11.5	6.1	5.1	7.3	7.3	6.1	7.2	8.4
Physicians' Fees	8.2	7.5	5.2	6.7	7.8	7.3	7.6	6.5
Dentists' Fees	6.2	8.8	6.5	5.5	6.2	7.3	6.3	6.6
Entertainment Services	6.4	4.8	5.3	5.8	4.3	4.7	5.3	6.2
Personal Care Services	5.6	3.2	4.8	4.0	2.8	3.8	4.5	5.2
Educational Services	11.1	9.5	9.9	8.4	8.1	8.0	7.6	7.8

Source: Bureau of Labor Statistics

The astute reader has no doubt noticed that most of the price indexes I have referred to so far are those which exclude food and energy. While it is true that neither are determined by the state of the economy—thus controllable by monetary policy—the fact remains that both are an integral part of budgets for businessmen and consumers. Thus it should be acknowledged that both have risen sharply of late, due to December's record cold wave that gripped most of the nation. But what the weather does, it can undo; January and February were extremely mild. Thus oil prices in spot markets have already retreated to pre-cold wave levels, sending producer prices of energy down five percent in February and gasoline in particular down more than two percent. And while food commodities are still climbing, they have risen only moderately from their 1989 low points—and are far below levels reached in the middle of 1988, when drought fears were at their worst.

People Run Faster To Stay Even

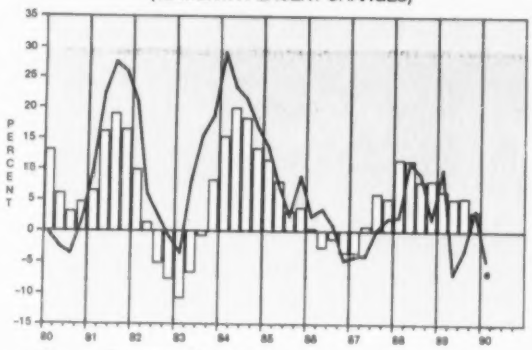
Most inflation bears would probably agree with this analysis, but would also point to the strength in employment as a harbinger of future trouble on the inflation front. This is because of two factors that may be derived from strong labor markets—big wage increases (which drive up costs), and large income gains (which boost potential demand). Thus, one should examine the state of the labor market to see if the ongoing rise in employment is, indeed, inflationary.

There is no denying that payroll employment has grown respectably—if not spectacularly—throughout this record-breaking business expansion. However, there is little reason for concern. First of all, growth has clearly slowed as business conditions have softened. Second, the payroll figures, as noted in the April 1989 Report, don't distinguish between single- and multiple-jobholders. The Labor Dept. reported later that year that the proportion of people holding down more than one job in 1989 was the highest in three decades! Is this inflationary, or is this merely an effort to keep pace with such expenses as rising Social Security taxes at the Federal level, and soaring property and sales taxes at the state and local level?

Ironically, the more people are trying to stay even with taxes, the harder they must run. Although nonfarm payrolls are nearly 25 percent larger today than they were at the end of the last recession, buying power of the average worker's earnings is actually two percent *lower*!

This reflects the fact that most of the job growth in this expansion has been in services, where wages are relatively low, as opposed to goods, which usually pay more. Indeed, if one goes back ten years, to the start of the 1980s, one finds that goods payrolls are actually three percent lower now; all of the payroll growth and then some has come in the service sector.

CHART II
NONFINANCIAL CORPORATE NET CASH FLOW
PUSHED FORWARD 1 QTR. (LINE)
VS. NONRESIDENTIAL FIXED INVESTMENT (BARS)
(12-MONTH PERCENT CHANGES)



Source: Commerce Department

Let's turn to labor costs. It may be true that unit labor costs are on the rise. Year-over-year, unit labor costs are now up by five percent—well above the postwar average of four percent, and the most for any 12-month period since the last recession. However, this is not so much a sign of a booming economy, as one that is soft, since as observed above, declining sales are preventing companies from spreading their costs over enough units of output. Indeed, over the past 30 years, unit labor costs rose the fastest while the economy was either in a recession—or about to enter one.

There is another reason why labor costs are climbing—and it doesn't have anything to do with the state of the labor market. Since the fourth quarter of 1987 a growing chunk of businesses' labor expense has occurred because of the rising cost of fringe benefits, namely Social Security taxes, the cost of medical care and reimbursement for education. Indeed, these latter two have for years risen at least twice as fast as the overall consumer price index, as the accompanying table plainly indicates.

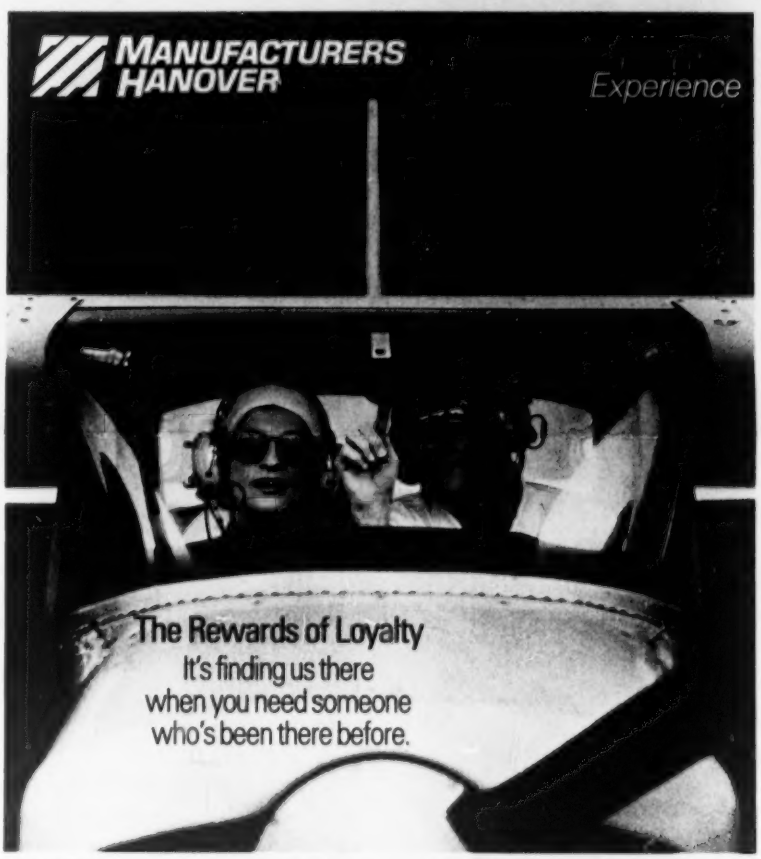
Policy Is Restraining Inflation

In the final analysis, inflation needs fuel to jump. Such fuel takes the form of rapid growth in the supply of money and credit. As has been pointed out time and again, inflation may have any one of a number of direct causes (wars, the weather, labor disputes, oil price hikes, a drop in the dollar's external value, etc.) which might boost prices of certain products or services temporarily. However, for these price hikes to become embedded in the overall price structure there must be excess liquidity. Absent rapid money growth, price increases in one sector of the economy would have to be compensated for by price cuts elsewhere, leaving the overall price level unchanged, for the most part.

Economists agree that money growth should not be more than is necessary to allow for some expansion in economic activity, plus a modest rate of inflation. Over the past year, the real GNP has gone up by 2.5 percent, while the GNP price index has risen 3.7 percent, for a total of 6.2 percent. Yet, during this same period, the broadest measure of the money supply, M-3, is up by only about three percent. This is not only not enough to fuel accelerating inflation— it may not even be enough to allow for economic growth.

The Fed is probably trying to compensate for the push the economy is still receiving from Washington's budget deficit. However, the deficit has fallen relative to the GNP—even after taking into account its partial masking by the mandatory purchases of Treasury securities by the Social Security and other trust funds. In particular, defense spending is falling—not only relative to the economy, but in absolute terms as well. Inflation-adjusted defense outlays, as measured in the Government's national income accounts, were four percent lower at the end of last year than they were two years earlier. Compared with the GNP, defense spending is now back to 1982 levels.

This is no small boost for inflation-fighters. For in the past, peak periods of inflation have coincided with rapid defense buildups. It's not hard to figure out why. Spending on defense-related items increases the demand for raw materials, productive capacity, and labor, without a corresponding increase in the availability of goods that occurs when the Government spends for nondefense purposes. Since defense spending was declining well before the relaxation of tensions between East and West became apparent, it is sure to fall even further in the months and years ahead, providing more assistance in the battle against inflation.



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